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CHINA CONTINUES TO MITIGATE ITS MACRO CONCERNS

Overview

The macroeconomic issues that plague China are well known. Critics question the sustainability of its growth and prophesy a catastrophic collapse, pointing to some difficult problems:

1. The country is accumulating too much debt at an unsustainable pace with the problem exacerbated by the burgeoning shadow banking sector. Every other country that has experienced this has gone through a crisis.
2. China is coming up against the middle-income trap, where it will be unable to progress to the next stage of growth.
3. Its bewildering web of inefficient state-owned enterprises is sucking up misallocated resources and contributing to the debt problem.
4. Its undemocratic government makes for an unstable system and an unsatisfactory social compact that cannot sustain long-term growth.

There is some truth to some of these issues, but we believe that China is able to engineer a soft landing and to sustain growth, albeit at a lower level than it is used to.

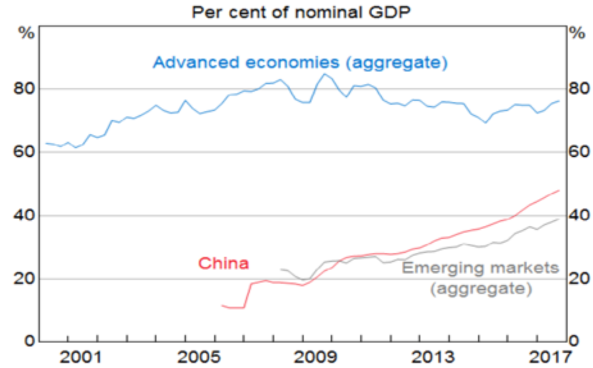
Economies that have experienced these problems typically face a crisis that pans out in one of two ways: 1) either like the Asian Financial Crisis (AFC) of 1997; 2) or the long-drawn two decades of no growth as experienced by Japan. We think that the first scenario is unlikely. China has a low chance of a crash like the AFC which was triggered by capital outflows and a weak banking system. China's debt is largely domestic and its capital controls act as flood barriers to prevent outflows that can damage the system. If the bears on China are right, the second scenario has a higher probability, with growth decelerating. If nothing were done to change course, it could become like a slow train wreck.

However, we think that China can avoid this as it has studied Japan's experience, identified its pitfalls and will not let history repeat itself. Japan had allowed the yen to grow overly-strong, the property and financial market bubbles to inflate unhindered and failed to push innovation in key industries. Unlike Japan, the Chinese leadership has strong political will to address these excesses with controls on the renminbi and various measures to fight the property and financial bubble.

Overcoming the shadow of excessive debt

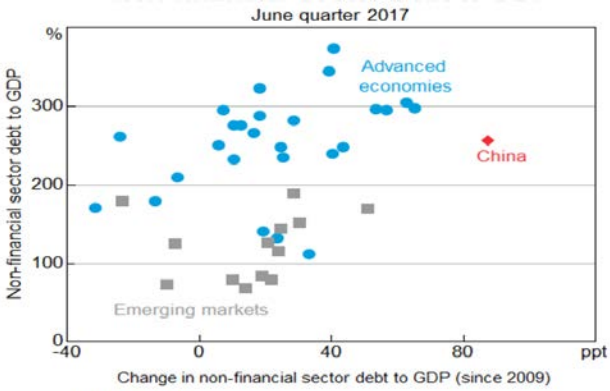
China's debt level is very high for an emerging market, and the rate of growth is high by any standards, giving rise to the worry that as the economy slows, much of this debt cannot be repaid. For example, household debt as a percentage of nominal GDP is close to 50 percent for China, outstripping the average for emerging markets at below 40 percent (Chart 1). The increase has been particularly pronounced in the last five years. China's non-financial sector debt to GDP has grown to be the highest among emerging markets at more than 250 percent, rising 80 percentage points in the last 8 years and outstripping growth in all the advanced economies (Chart 2).

Chart 1: Household Debt



Source: BIS, May 2018

Chart 2: Non-financial Sector Debt to GDP

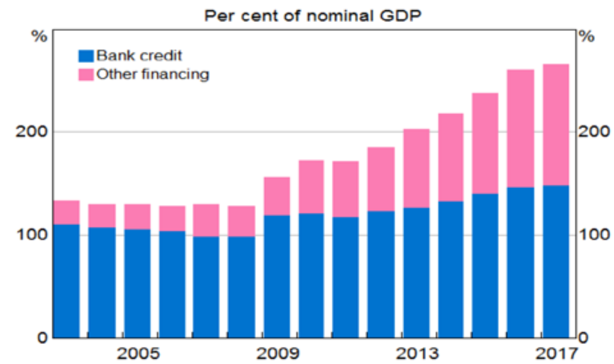


Source: BIS, RBA, May 2018

In addition, much of this debt is not in the traditional banking system, but is in the shadow banking sector. Bank credit has grown at a relatively stable rate, hovering at below 150 percent of GDP, while non-bank financing has grown exponentially in the last eight years from constituting less than 50 percent of GDP in 2009 to almost 100 percent of GDP in

2017 (Chart 3). The ballooning shadow banking sector can be seen from the growth in wealth management products (WMP) that were virtually non-existent in 2008 to now totaling almost RMB 30 trillion, and entrusted loans similarly growing to almost RMB 15 trillion in 2017. This growth in the shadow banking sector, if left unregulated and unchecked, increases the risk in the financial sector which in the extreme could become much like what we saw in the Global Financial Crisis of 2008.

Chart 3: China – Non-financial Sector Debt



Source: CEIC data, RBA, May 2018

The concern is that in an environment with a young entrepreneurial business culture where many players have neither seen a recession nor a credit crunch, it is inevitable that credit approvals will be too lax and businesses use more debt than is prudent. As growth slows, even more debt will need to be added to keep the economic engine revving, or else it will keel over and collapse, leaving a mountain of unpaid debts.

While we acknowledge these risks, we think China will be able to avert a hard landing. For one thing, the debt in the system is nearly all local, so the chances of a 1997 Asian Financial Crisis-type collapse where foreigners withdraw their funds, are virtually non-existent. The government's controls on the capital account means that the danger of capital flight is very low. In addition, the government is cognizant of the dangers of the excessive debt growth and has taken steps to curb it, with some signs of this bearing fruit. It has not been afraid to engineer an economic slowdown to achieve this, with attempts to channel credit to higher capital value-added areas. While it has not yet been able to reverse the debt growth, government-enacted measures have retarded and caused debt levels to creep sideways. For example, the increase in China banks' claims on non-bank financial institutions (NBFIs) has slowed to near-zero in 2017 from almost 30 percent in the previous year.

Minding the middle income trap

With China's rapid development and ascent, its economy has reached a middle income stage where traditionally, growth slows and plateaus, and it becomes difficult for the country to become wealthier. It is normally argued that in the early part of a country's development where there is a lack of capital, wherever capital is invested it reaps huge returns. Over time, returns diminish as the access to cheap labour such as those from the countryside, which had hitherto contributed to the easy gains, diminishes. With the low-hanging fruit having been picked, the growth model needs to evolve to adjust to higher costs as wages start to rise quickly. There is a need to move to a more services-led, consumer-driven and less capital expenditure-dependent economy. The people and businesses that had done well from the first stage of development fight the changes that are necessary and the economy is caught in the 'middle income trap'.

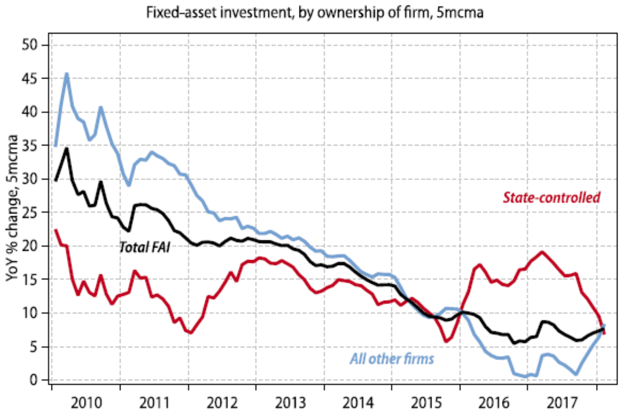
Having witnessed how its East Asian peers such as South Korea, Taiwan and Japan sailed into crises without realizing or taking action, China is aware and bent on averting the same fate. Japan suffered a lost two decades with economic stagnation when the yen was allowed to become too strong, the property bubble grew out of hand and companies speculating in real estate bought too many trophy assets overseas. These finally came to a head when the financial market bubble burst. It is easy to get hooked on living in rose-tinted revelry and hard to pull back or change course to avoid a crash landing when things are going well.

China's advances in economic reforms in the past three years such as most provinces issuing policies to grant migrant workers household residency, and implementing measures to address their housing, education and other basic needs, are a step in the right direction. The government has pushed forward with liberalization, giving foreign firms greater access to its market. This includes lifting the ceiling for foreign holdings in financial joint ventures and allowing credit rating agencies to do business without Chinese partners. We think with concerted effort at continuing reforms, China has a good chance of avoiding the middle income trap.

Ridding inefficiencies in state-owned enterprises

An important element in averting an economic meltdown hinges on the success of reforming state-owned enterprises (SOEs). China's SOEs have access to a larger share of the finance in the economy than their share of activity and is also blamed for the mounting corporate debt that critics point to as a ticking economic time bomb. In 2016 and 2017, the growth rate of capital expenditure for private firms was much less than that of state-controlled firms, suggesting that the private sector was more cautious about the future and that SOEs were partly pumping up the economy (chart 4). SOEs are seen as having multiple objectives: Besides making profits they are tasked with developing or acquiring technology for the country, providing jobs and doing "national service" when required.

Chart 4: Private investment is picking up as state-led investment cools



Source: CEIC, Gavakel Data/Macrobond, Jul 2018

An initial stage of ridding inefficiencies in the SOEs was supply-side reforms where production limits were set to cap capacity in the centrally-planned command economy. This was needed in some sectors with over-capacity such as steel and coal to staunch the bleeding from irrational competition. The second stage of reform was in stopping new capacity. We have now entered a third stage where China is forcing consolidation and reducing the number of SOEs through bankruptcies, debt restructuring and mega mergers. The consolidation sees the weaker SOEs merged with their stronger peers, as well as vertical integration to create "national champions" in respective industries that can compete globally.

Political system that is unabashedly undemocratic

In March this year (2018), China's National People's Congress approved constitutional changes to remove term limits for China's President. This raised some concerns among critics who questioned the wisdom of allowing President Xi Jinping to effectively remain President for life or rule indefinitely, pointing to the undemocratic nature of such a move. Those schooled in Western liberal democracy hold the implicit assumption that democracy and capitalism are the best systems of governance. It is thought that the free market allocates capital more efficiently than a command economy where bureaucrats, tasked with directing resources into the right sectors, always get it wrong. The view is that democracy is a fairer system for the average person and is better at preventing corruption and despotic rule.

The Chinese system of "socialism with Chinese characteristics" is clearly very different from liberal democracy but we think that being at odds with this Western ideal does not mean it is inferior or doomed to fail. Every country interprets events through the lens of its own history, culture and way of thinking. China sees itself as needing to be governed from the centre due to its size. The confidence that such a system serves it well in part stems from its history where there are many examples of great emperors who served the people well.

The German sociologist and philosopher Max Weber defines authority as taking three forms: 1) charismatic; 2) traditional; and 3) legal-rational. Each of these translates into a different type of leadership. First, a charismatic leader has traits that make him extraordinary. He is not just capable but has the power of charisma to unite divided people to follow him. In the second form of traditional authority, the leader, though possessing a dominant personality, depends on established tradition or the prevailing order in society, for his mandate to rule. The third form, legal-rational authority is derived from clearly defined laws. It is not the innate qualities of the leader that enables him to lead, but the procedures and laws which give him legitimacy and competency to rule. Much of contemporary society depends on this form of rational authority as the rule of law, with a bureaucracy developed to establish order and address problems.

Chinese scholars such as Peking University law professor Jiang Shigong[1] argue that President Xi has all three forms of authority. He has legal authority as Party Secretary and President, traditional authority being "borne of the Party's historical tradition" and most importantly, has special "charismatic authority". It can be argued that Xi is the first of China's modern leaders to possess all 3 forms of authority. With this, he is able to push through the crucial reforms needed for steering the China behemoth toward a sustainable growth path.

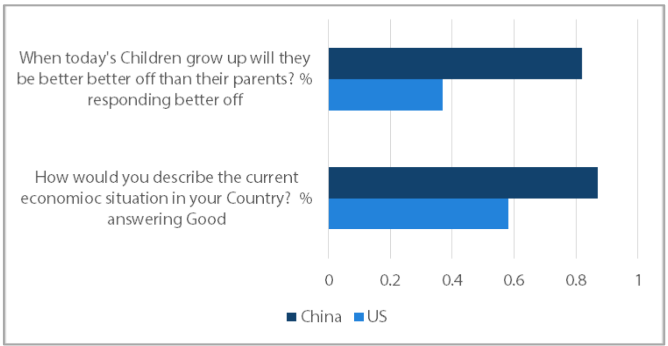
Reform is about identifying the issues, devising a solution, having the power to implement the solution and being prepared to use that power. Xi has on many occasions talked about the three battles China needs to fight: against poverty, pollution and excessive leverage and speculation in the financial sector. Thus, he clearly acknowledges the issues – unlike the United States before the Global Financial Crisis or most Asian countries before the Asian Financial Crisis. Xi clearly has the authority, and is arguably much stronger than any other global leader of a major country. He has put in place technocrats to come up with solutions such as vice-premier Liu He, a trained economist, and central bank governor Yi Gang. President Xi has also shown that he is not afraid to use his authority, such as in his crackdown on corruption.

As a nod to the popularity and acceptance of President Xi, the average Chinese has professed a favourable view of the economy and is optimistic about the future. Surveys done by The Pew Research Center show that close to 90 percent of respondents in China think their current economic situation is good, compared to the US (Chart 5), where the rate hovers at 50 percent. As a barometer of sentiment towards the future, more than 80 percent of Chinese think their children will be financially better off than them, contrast that with the US where less than 40 percent think so. Hence it seems that the

[1] Source: Open Times "Philosophy and History: Interpreting the 'Xi Jinping Era' through Xi's Report to the Nineteenth National Congress of the CCP", Jan 2018

populace is satisfied with the state of affairs and so political risk is very low in China.

Chart 5: Pew Survey of Views on Own Economy



Source: Pew Research Centre, Jun 2018

Pulling it all together – why this time it's different

While China has embarked on many reforms in the past, what is different this time, giving us confidence that it will succeed, is the presence of a strong leader in the form of President Xi Jinping. The process of reform involves some hardship and there is a need for the determined will of a commander-in-chief to stay the course and persuade his constituents that the pain they endure is worth the benefits in the long run. The changes needed to avoid the middle income trap and make the hard decisions to deflate the shadow banking sector are best made by either a centralised system with a strong leader – as in China's case, or by a democracy whose leader has won a very strong mandate for reform.

In China's case, President Xi is a charismatic leader with real authority and he has put in place competent people and the machinery to ensure his decisions are complied with. They have charted a long-term plan and are addressing issues such as those in the financial sector. A few years ago, one could accuse China of allowing excessive growth in shadow banking and not controlling its SOEs, but we believe this is being addressed. China's success in arresting the growth of shadow banking is all the more remarkable in that this has occurred without a major slowdown in the economy. In fact, economic growth in 2017 accelerated to 6.8% from 6.7%, the first acceleration in 7 years.

In the area of SOE reform, this has taken on various guises in the past but we think that under President Xi, this time the clean-up and consolidation is more promising. Supply side reform, which at first looked like government sponsored old fashioned oligopolies, have been very successful in the coal and steel sectors. Excess inefficient supply have been taken out and new capacity additions reduced. Consolidation is now an important part of moving the SOEs to another level to reap higher returns on capital. Traditionally, many SOEs have had supporters in various levels of government that hindered consolidation as rent-seeking bureaucrats protected their turf. Under the new regime with the clear direction of President Xi, consolidation is taking place and should lead to less wasted capex as well as higher returns in the future.

With the deliberate attempts to curb the shadow banking sector, economic growth will slow in the short term. But that is a good thing, with the focus shifting to quality growth and reform. Issues almost always crop up when things are coasting along, regulators are complacent or powerless to act.

The emphasis is now on developing the services sector, which implicitly has lower returns compared with the early stages of development where rolling out factories reaped easy gains. The long-term goal would be to transform the economic structure with a pullback from reliance on exports and getting rid of the weaknesses in the economy. Navigating the pitfalls of the middle income trap would mean addressing the income inequality that is slowly but surely creeping into the system. Successfully achieving this would forge a more harmonious and stronger society.

Having studied the Japanese experience and concluding that one of its mistakes was in failing to drive industries to further innovate, China has crafted policies to address this. The Made in China (MIC) 2025 initiative is one such industrial policy aimed at propelling the nation onto the world stage and key to securing its future as a major player in global industries. China has and will continue to invest significant amounts of capital in these industries to achieve its goals, and if allowed to, would buy companies that have globally strong intellectual property. Despite the bellicose trade rhetoric from the US, which is partly aimed at MIC 2025, it is very unlikely that China will change what it is trying to achieve. In fact, the recent US trade ban on ZTE which brought the Chinese telecommunications company to its knees, would only serve to bolster China's determination to cut its reliance on the US and acquire or devise its own technology.

President Xi has noted in past speeches that China had missed the industrial revolution, which was a key reason for its weakness in the 19th and 20th centuries, so it cannot afford to fall behind in the current technology and data revolution.

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